

PEOPLES FINANCIAL SERVICES CORP.  
Form 10-Q  
August 10, 2009

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

Form 10-Q

(X) Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2009 or

( ) Transition report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the transition period from

No. 0-23863  
(Commission File Number)

PEOPLES FINANCIAL SERVICES CORP.  
(Exact Name of Registrant as Specified in its Charter)

Pennsylvania  
(State of Incorporation)

23-2391852  
(IRS Employer ID Number)

82 Franklin Avenue  
Hallstead, PA  
(Address of Principal Executive Offices)

18822  
(Zip Code)

(570) 879-2175  
(Registrant's Telephone Number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months or for such shorter period that the registrant was required to file such reports, and (2) has been subject to such filing requirements for the past 90 days. Yes X No \_\_\_

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes X No \_\_\_

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer \_\_\_ Accelerated filer X Non-accelerated filer \_\_\_ Smaller reporting company \_\_\_  
(Do not check if smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes \_\_\_ No X

Number of shares outstanding as of July 31, 2009

|                              |                      |
|------------------------------|----------------------|
| COMMON STOCK (\$2 Par Value) | 3,134,656            |
| (Title of Class)             | (Outstanding Shares) |

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PEOPLES FINANCIAL SERVICES CORP.  
FORM 10-Q

For the Quarter Ended June 30, 2009

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

PEOPLES FINANCIAL SERVICES CORP.  
CONSOLIDATED BALANCE SHEETS (UNAUDITED)

June 30, 2009 and December 31, 2008

(In thousands, except share and per share data)

|   | June 2009 | Dec 2008  |
|---|-----------|-----------|
| <b>ASSETS:</b>  |           |           |
| Cash and due from banks   | \$6,888   | \$6,174   |
| Interest bearing deposits in other banks  | 769       | 1,782     |
| Federal funds sold  | 5,597     | 10,577    |
| Cash and cash equivalents   | 13,254    | 18,533    |
| Securities available for sale   | 103,349   | 110,247   |
| Loans   | 318,569   | 316,608   |
| Allowance for loan losses   | (2,928 )  | (3,002 )  |
| Loans, net  | 315,641   | 313,606   |
| Bank premises and equipment, net  | 7,337     | 7,542     |
| Accrued interest receivable   | 2,733     | 2,526     |
| Intangible assets   | 689       | 818       |
| Other real estate owned   | 5,440     | 5,171     |
| Bank owned life insurance   | 8,081     | 7,911     |
| Other assets  | 6,082     | 6,022     |
| Total assets  | \$462,606 | \$472,376 |
| <b>LIABILITIES:</b>   |           |           |
| Deposits:   |           |           |
| Non-interest bearing  | \$65,160  | \$55,324  |
| Interest bearing  | 295,216   | 315,944   |
| Total deposits  | 360,376   | 371,268   |
| Accrued interest payable  | 438       | 1,649     |
| Short-term borrowings   | 20,022    | 18,432    |
| Long-term borrowings  | 39,191    | 39,691    |
| Other liabilities   | 1,287     | 1,616     |
| Total liabilities   | 421,314   | 432,656   |
| <b>STOCKHOLDERS' EQUITY:</b>  |           |           |
| Common Stock, par value \$2 per share; authorized 12,500,000 shares; issued 3,341,251 shares; outstanding 3,134,656 shares and 3,131,181 shares June 30, 2009 and December 31, 2008, respectively | 6,683     | 6,683     |
| Surplus   | 3,099     | 3,100     |
| Retained earnings   | 40,959    | 39,375    |
| Accumulated other comprehensive loss  | (4,826 )  | (4,755 )  |
| Treasury stock at cost 206,595 and 210,070 shares at June 30, 2009 and December 31, 2008, respectively  | (4,623 )  | (4,683 )  |
| Total stockholders' equity  | 41,292    | 39,720    |
| Total liabilities and stockholders' equity  | \$462,606 | \$472,376 |

See Notes to Consolidated Financial Statements



PEOPLES FINANCIAL SERVICES CORP.  
CONSOLIDATED STATEMENTS OF INCOME  
(UNAUDITED)

(In thousands, except share and per share data)

|   | Three Months Ended |         | Six Months Ended |         |
|---|--------------------|---------|------------------|---------|
|   | June 30            | June 30 | June 30          | June 30 |
|   | 2009               | 2008    | 2009             | 2008    |
| <b>INTEREST INCOME:</b>   |                    |         |                  |         |
| Loans receivable, including fees                                      | \$4,880            | \$4,927 | \$9,724          | \$9,949 |
| <b>Securities:</b>  |                    |         |                  |         |
| Taxable   | 693                | 974     | 1,517            | 1,940   |
| Tax exempt  | 530                | 401     | 1,031            | 818     |
| Other   | 5                  | 6       | 20               | 12      |
| Total interest income   | 6,108              | 6,308   | 12,292           | 12,719  |
| <b>INTEREST EXPENSE:</b>  |                    |         |                  |         |
| Deposits  | 1,204              | 1,631   | 2,866            | 3,491   |
| Short-term borrowings   | 85                 | 69      | 152              | 201     |
| Long-term borrowings  | 404                | 448     | 806              | 890     |
| Total interest expense  | 1,693              | 2,148   | 3,824            | 4,582   |
| Net interest income   | 4,415              | 4,160   | 8,468            | 8,137   |
| <b>PROVISION FOR LOAN LOSSES</b>                                      | 1,040              | 135     | 1,205            | 255     |
| Net interest income after provision for loan losses                   | 3,375              | 4,025   | 7,263            | 7,882   |
| <b>OTHER INCOME:</b>  |                    |         |                  |         |
| Customer service fees   | 479                | 509     | 929              | 978     |
| Investment division commission income                                 | 119                | 76      | 225              | 160     |
| Earnings on investment in life insurance                              | 82                 | 76      | 170              | 155     |
| Other income  | 330                | 141     | 494              | 263     |
| Net realized gains (losses) on sales of securities available for sale | 339                | (10 )   | 518              | 16      |
| Other than temporary security impairment                              | (60 )              | (83 )   | (136 )           | (265 )  |
| Total other income  | 1,289              | 709     | 2,200            | 1,307   |
| <b>OTHER EXPENSES:</b>  |                    |         |                  |         |
| Salaries and employee benefits  | 1,365              | 1,130   | 2,706            | 2,340   |
| Occupancy   | 200                | 174     | 439              | 372     |
| Equipment   | 131                | 114     | 275              | 239     |
| FDIC insurance and assessments  | 453                | 38      | 544              | 75      |
| Professional fees and outside services                                | 138                | 115     | 276              | 285     |
| Computer services and supplies  | 279                | 230     | 526              | 461     |
| Taxes, other than payroll and income                                  | 114                | 87      | 210              | 177     |
| Amortization expense-deposit acquisition premiums                     | 64                 | 64      | 129              | 129     |
| Stationary and printing supplies                                      | 93                 | 92      | 183              | 170     |
| Other   | 381                | 470     | 851              | 927     |
| Total other expenses  | 3,218              | 2,514   | 6,139            | 5,175   |
| Income before income taxes  | 1,446              | 2,220   | 3,324            | 4,014   |
| <b>INCOME TAXES</b>   | 193                | 516     | 550              | 895     |
| Net income  | \$1,253            | \$1,704 | \$2,774          | \$3,119 |
| Net income per share, basic   | \$0.40             | \$0.54  | \$0.89           | \$1.00  |

|                               |        |        |        |        |
|-------------------------------|--------|--------|--------|--------|
| Net income per share, diluted | \$0.40 | \$0.54 | \$0.89 | \$1.00 |
|-------------------------------|--------|--------|--------|--------|

See Notes to Consolidated Financial Statements



PEOPLES FINANCIAL SERVICES CORP.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
FOR THE SIX MONTHS ENDED JUNE 30, 2009 AND 2008  
(UNAUDITED)

| (In thousands except share data)   | Common<br>Stock | Surplus | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock | Total    |
|--|-----------------|---------|----------------------|---|-------------------|----------|
| Balance, December 31, 2008   | \$6,683         | \$3,100 | \$39,375             | \$ (4,755 )                                   | \$(4,683 )        | \$39,720 |
| Comprehensive income   |                 |         |                      |   |                   |          |
| Net income   | 0               | 0       | 2,774                | 0   | 0                 | 2,774    |
| Net change in unrealized losses on securities available for sale, net of reclassification adjustment and taxes | 0               | 0       | 0                    | (71 )   | 0                 | (71 )    |
| Total comprehensive income   |                 |         |                      |   |                   | 2,703    |
| Cash dividends, (\$0.38 per share)   | 0               | 0       | (1,190 )             | 0   | 0                 | (1,190 ) |
| Treasury stock issued for stock option plan (3,475 shares)   | 0               | (1 )    | 0                    | 0   | 60                | 59       |
| Balance, June 30, 2009   | \$6,683         | \$3,099 | \$40,959             | \$ (4,826 )                                   | \$(4,623 )        | \$41,292 |
| Balance, December 31, 2007   | \$6,683         | \$3,083 | \$38,824             | \$ (1,390 )                                   | \$(4,395 )        | \$42,805 |
| Cumulative effect of adoption of new accounting principle on January 1, 2008                                   | 0               | 0       | (71 )                | 0   | 0                 | (71 )    |
| Comprehensive income   |                 |         |                      |   |                   |          |
| Net income   | 0               | 0       | 3,119                | 0   | 0                 | 3,119    |
| Net change in unrealized losses on securities available for sale, net of reclassification adjustment and taxes | 0               | 0       | 0                    | (2,542 )                                      | 0                 | (2,542 ) |
| Total comprehensive income   |                 |         |                      |   |                   | 577      |
| Stock option expense   | 0               | 1       | 0                    | 0   | 0                 | 1        |
| Cash dividends, (\$0.38 per share)   | 0               | 0       | (1,226 )             | 0   | 0                 | (1,226 ) |
| Treasury stock purchase (20,000 shares)  | 0               | 0       | 0                    | 0   | (506 )            | (506 )   |
| Treasury stock issued for stock option plan (9,688 shares)   | 0               | 9       | 0                    | 0   | 167               | 176      |
| Balance, June 30, 2008   | \$6,683         | \$3,093 | \$40,646             | \$ (3,932 )                                   | \$(4,734 )        | \$41,756 |

See Notes to Consolidated Financial Statements



PEOPLES FINANCIAL SERVICES CORP.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

| (In thousands)   | Six Months Ended |               |
|--|------------------|---------------|
|  | June 30, 2009    | June 30, 2008 |
| Cash Flows from Operating Activities   |                  |               |
| Net income   | \$ 2,774         | \$ 3,119      |
| Adjustments to reconcile net income to net cash provided by operating activities:            |                  |               |
| Depreciation and amortization  | 479              | 430           |
| Provision for loan losses  | 1,205            | 255           |
| Gain on sale of other real estate owned  | 0                | (15 )         |
| Amortization of securities' premiums and accretion of discounts, net                         | 129              | 82            |
| Amortization of deferred loan costs  | 165              | 176           |
| Gains on sales of securities available for sale, net   | (518 )           | (16 )         |
| Other than temporary security impairment   | 136              | 265           |
| Stock option expense   | 0                | 1             |
| Proceeds from the sale of loans originated for sale  | 16,140           | 3,420         |
| Net gain on sale of loans originated for sale  | (165 )           | (35 )         |
| Loans originated for sale  | (12,840 )        | (3,258 )      |
| Net earnings on investment in life insurance   | (170 )           | (155 )        |
| Increase in accrued interest receivable  | (207 )           | (519 )        |
| Increase in other assets   | (24 )            | (89 )         |
| Increase (decrease) in accrued interest payable  | (1,211 )         | 276           |
| Decrease in other liabilities  | (329 )           | (585 )        |
| Net cash provided by operating activities  | 5,564            | 3,352         |
| Cash Flows from Investing Activities   |                  |               |
| Proceeds from sale of available for sale securities  | 27,804           | 46,018        |
| Proceeds from maturities of and principal payments received on available for sale securities | 7,054            | 4,273         |
| Purchase of available for sale securities  | (27,814 )        | (52,875 )     |
| Net increase in loans  | (6,767 )         | (7,439 )      |
| Purchase of premises and equipment   | (145 )           | (788 )        |
| Investment in other real estate owned  | (42 )            | 0             |
| Proceeds from sale of other real estate owned  | 0                | 180           |
| Net cash provided by (used in) investing activities  | 90               | (10,631 )     |
| Cash Flows from Financing Activities   |                  |               |
| Cash dividends paid  | (1,190 )         | (1,226 )      |
| Increase (decrease) in deposits  | (10,892 )        | 11,446        |
| Proceeds from long-term borrowings   | 0                | 5,000         |
| Repayment of long-term borrowings  | (500 )           | (718 )        |
| Increase (decrease) in short-term borrowings   | 1,590            | (5,224 )      |
| Purchase of treasury stock   | 0                | (506 )        |
| Proceeds from sale of treasury stock   | 59               | 176           |
| Net cash provided by (used in) financing activities  | (10,933 )        | 8,948         |
| Net increase (decrease) in cash and cash equivalents   | (5,279 )         | 1,669         |
| Cash and cash equivalents, beginning of year   | 18,533           | 8,606         |

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|  |           |           |
|--|-----------|-----------|
| Cash and cash equivalents, end of period   | \$ 13,254 | \$ 10,275 |
| Supplemental disclosures of cash paid  |           |           |
| Interest paid  | \$ 5,035  | \$ 4,306  |
| Income taxes paid  | \$ 815    | \$ 1,030  |
| Non-cash investing and financing activities  |           |           |
| Transfers from loans to other real estate owned through foreclosure                | \$ 227    | \$ 99     |
| Consideration received for exchange of securities available for sale (see page 34) | \$ 526    | \$ 0      |

See Notes to Consolidated Financial Statements

## NOTE 1. BASIS OF PRESENTATION

The consolidated financial statements include the accounts of Peoples Financial Services Corp. (the “Corporation” or the “Company”) and its wholly owned subsidiaries, Peoples National Bank (the “Bank”), Peoples Advisors, LLC (“Advisors”), and Peoples Financial Capital Corporation. The Bank has two wholly owned subsidiaries, Peoples Financial Leasing, LLC and Peoples Investment Holdings, LLC. All material inter-company accounts and transactions have been eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information as well as with instructions for Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the six-month period ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ended December 31, 2009. For further information, refer to the consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2008.

Effective April 1, 2009, the Company adopted Statement of Financial Accounting Standards (“SFAS”) No. 165, Subsequent Events. SFAS No. 165 establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. SFAS No. 165 sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that should be made about events or transactions that occur after the balance sheet date. In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred between June 30, 2009 through August 10, 2009, the date these consolidated financial statements were issued.

## NOTE 2. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | June 30,<br>2009   | June 30,<br>2008 | June 30,<br>2009 | June 30,<br>2008 |
| Net income applicable to common stock   | \$1,253,000        | \$1,704,000      | \$2,774,000      | \$3,119,000      |
| Weighted average common shares outstanding  | 3,133,480          | 3,126,855        | 3,132,353        | 3,125,284        |
| Effect of dilutive securities, stock options  | 120                | 5,139            | 274              | 6,058            |
| Weighted average common shares outstanding used to calculate diluted earnings per share | 3,133,600          | 3,131,994        | 3,132,627        | 3,131,342        |
| Basic earnings per share  | \$0.40             | \$0.54           | \$0.89           | \$1.00           |
| Diluted earnings per share  | \$0.40             | \$0.54           | \$0.89           | \$1.00           |

Stock options for 23,429 and 11,959 shares of common stock were not considered in computing diluted earnings per share for the three and six months ended June 30, 2009 and for the three and six months ended June 30, 2008, respectively because they are antidilutive.



## NOTE 3. SECURITIES AVAILABLE FOR SALE

At June 30, 2009 and December 31, 2008, the amortized cost and fair values of securities available-for-sale are as follows:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value  |
|---|-------------------|------------------------------|-------------------------------|-------------|
|   | (In Thousands)    |                              |                               |             |
| June 30, 2009:  |                   |                              |                               |             |
| U.S. Government agencies and corporations               | \$15,239          | \$45                         | \$(351)                       | ) \$14,933  |
| Obligations of state and political subdivisions         | 52,718            | 170                          | (2,769)                       | ) 50,119    |
| Taxable obligations of state and political subdivisions | 5,759             | 24                           | (214)                         | ) 5,569     |
| Corporate debt securities                               | 20,827            | 18                           | (3,839)                       | ) 17,006    |
| Mortgage-backed securities                              | 11,422            | 239                          | (45)                          | ) 11,616    |
| Preferred equity securities                             | 78                | 0                            | (36)                          | ) 42        |
| Common equity securities                                | 4,618             | 13                           | (567)                         | ) 4,064     |
| Total   | \$110,661         | \$509                        | \$(7,821)                     | ) \$103,349 |
| December 31, 2008:                                      |                   |                              |                               |             |
| U.S. Government agencies and corporations               | \$7,891           | \$67                         | \$0                           | ) \$7,958   |
| Obligations of state and political subdivisions         | 47,914            | 120                          | (3,319)                       | ) 44,715    |
| Taxable obligations of state and political subdivisions | 3,166             | 0                            | (106)                         | ) 3,060     |
| Corporate debt securities                               | 20,828            | 40                           | (3,898)                       | ) 16,970    |
| Mortgage-backed securities                              | 32,487            | 325                          | (47)                          | ) 32,765    |
| Preferred equity securities                             | 78                | 0                            | (58)                          | ) 20        |
| Common equity securities                                | 5,086             | 0                            | (327)                         | ) 4,759     |
| Total   | \$117,450         | \$552                        | \$(7,755)                     | ) \$110,247 |

The amortized cost and fair value of securities as of June 30, 2009, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without any penalties.

|  | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
|  | (In Thousands)    |               |
| Due in one year or less                | \$ 1,321          | \$ 1,324      |
| Due after one year through five years  | 6,689             | 5,844         |
| Due after five years through ten years | 29,970            | 27,115        |
| Due after ten years                    | 56,563            | 53,344        |
|  | 94,543            | 87,627        |
| Mortgage-backed securities             | 11,422            | 11,616        |
| Equity securities                      | 4,696             | 4,106         |
|  | \$ 110,661        | \$ 103,349    |

Proceeds from sale of available-for-sale securities during the six months ended June 30, 2009 and 2008 and the year ended December 31, 2008 were \$27,804,000, \$46,018,000, and \$57,997,000, respectively. Gross gains realized on these sales were \$280,000, \$298,000, and \$412,000, respectively. Gross losses on these sales were \$9,000, \$268,000, and \$284,000, respectively.

Securities with a carrying value of \$42,493,000 and \$44,313,000 at June 30, 2009 and December 31, 2008, respectively, were pledged to secure public deposits and repurchase agreements as required or permitted by law.

The following tables show the Company's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2009 and December 31, 2008 (in thousands):

June 30, 2009:

|   | Less Than 12 Months |                      | 12 Months or More |                      | Total      |                      |
|---|---------------------|----------------------|-------------------|----------------------|------------|----------------------|
|   | Fair Value          | Unrealized<br>Losses | Fair Value        | Unrealized<br>Losses | Fair Value | Unrealized<br>Losses |
| U.S. Government agencies and corporations               | \$11,953            | \$(351 )             | \$0               | \$0                  | \$11,953   | \$(351 )             |
| Obligations of state and political subdivisions         | 15,754              | (338 )               | 25,393            | (2,431 )             | 41,147     | (2,769 )             |
| Taxable obligations of state and political subdivisions | 3,085               | (82 )                | 866               | (132 )               | 3,951      | (214 )               |
| Corporate debt securities                               | 734                 | (23 )                | 14,512            | (3,816 )             | 15,246     | (3,838 )             |
| Mortgage-backed securities                              | 4,275               | (44 )                | 158               | (1 )                 | 4,433      | (45 )                |
| Preferred equity securities                             | 42                  | (36 )                | 0                 | 0                    | 42         | (36 )                |
| Common equity securities                                | 37                  | (113 )               | 588               | (454 )               | 625        | (567 )               |
| Total Temporarily Impaired Securities                   | \$35,880            | \$(987 )             | \$41,517          | \$(6,834 )           | \$77,397   | \$(7,821 )           |





December 31, 2008:

|   | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| Obligations of state and political subdivisions         | \$34,301            | \$(2,376 )        | \$2,570           | \$(943 )          | \$36,871   | \$(3,319 )        |
| Taxable obligations of state and political subdivisions | 3,060               | (106 )            | 0                 | 0                 | 3,060      | (106 )            |
| Corporate debt securities                               | 8,752               | (2,878 )          | 7,420             | (1,020 )          | 16,172     | (3,898 )          |
| Mortgage-backed securities                              | 11,242              | (41 )             | 1,305             | (6 )              | 12,547     | (47 )             |
| Preferred equity securities                             | 20                  | (58 )             | 0                 | 0                 | 20         | (58 )             |
| Common equity securities                                | 166                 | (37 )             | 687               | (290 )            | 853        | (327 )            |
| Total Temporarily Impaired Securities                   | \$57,541            | \$(5,496 )        | \$11,982          | \$(2,259 )        | \$69,523   | \$(7,755 )        |

As of June 30, 2009 the Company had 8 (all less than 12 months) U.S. Government Agency securities, 80 (46 less than 12 months, 34 greater than 12 months) obligations of state and political subdivisions, 11 (1 less than 12 months, 10 greater than 12 months) corporate debt securities, 6 (3 less than 12 months, 3 greater than 12 months) mortgage-backed securities, 2 (both less than 12 months) preferred equity securities and 17 (1 less than 12 months, 16 greater than 12 months) common equity securities in an unrealized loss position. The majority of the unrealized losses reflect changes in interest rates subsequent to the acquisition of the specific securities and management believes that these unrealized losses represent a temporary impairment of those securities. As long-term rates increase, the underlying value of securities owned by the Company decreases, creating an unrealized loss.

The Company recorded other than temporary impairments of \$136,000 for the six months ended June 30, 2009. These impairments were the result of writing down two separate common equity securities. These write-downs were measured based on public market prices. In reaching the determination to record these impairments, management reviewed the facts and circumstances available surrounding the securities, including the duration and amount of the unrealized loss, the financial condition of the issuer and the prospects for a change in market value within a reasonable period of time. Based on its assessment, management determined that the impairment was other-than-temporary and that a charge was appropriate for these securities.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. All of the Company’s investment securities classified as available-for-sale are evaluated for OTTI under SFAS 115, Accounting for Certain Investments in Debt and Equity Securities.

In determining OTTI under the SFAS 115 model, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than amortized cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

When an OTTI occurs under the model, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors shall be recognized in other comprehensive income, net of applicable tax benefit. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment. As of June 30, 2009 the Company has the intent and ability to hold such securities until maturity or market price recovery. Management believes that the unrealized losses represent temporary impairment of the securities.

As a member of the Federal Home Loan Bank of Pittsburgh ("FHLB"), the Company is required to purchase and hold stock in the FHLB to satisfy membership and borrowing requirements. This stock is restricted in that it can only be sold to the FHLB or to another member institution, and all sales of FHLB stock must be at par. As a result of these restrictions, FHLB stock is unlike other investment securities insofar as there is no trading market for FHLB stock and the transfer price is determined by FHLB membership rules and not by market participants. As of June 30, 2009 and December 31, 2008, our FHLB stock totaled \$2.771 million and \$2.559 million, respectively.

In December 2008, the FHLB voluntarily suspended dividend payments on its stock, as well as the repurchase of excess stock from members. The FHLB cited a significant reduction in the level of core earnings resulting from lower short-term interest rates, the increased cost of liquidity, and constrained access to the debt markets at attractive rates and maturities as the main reasons for the decision to suspend dividends and the repurchase of excess capital stock. The FHLB last paid a dividend in the third quarter of 2008.

FHLB stock is held as a long-term investment and its value is determined based on the ultimate recoverability of the par value. The Company evaluates impairment quarterly. The decision of whether impairment exists is a matter of judgment that reflects our view of the FHLB's long-term performance, which includes factors such as the following:

- its operating performance;
- the severity and duration of declines in the fair value of its net assets related to its capital stock amount;
- its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance;
- the impact of legislative and regulatory changes on the FHLB, and accordingly, on the members of FHLB; and
- its liquidity and funding position.

After evaluating all of these considerations, the Company concluded that the par value of its investment in FHLB stock will be recovered. Accordingly, no impairment charge was recorded on these securities for the six and three months ended June 30, 2009. Our evaluation of the factors described above in future periods could result in the recognition of impairment charges on FHLB stock.

#### NOTE 4. OTHER COMPREHENSIVE INCOME

The components of other comprehensive income (loss) and related tax effects for the six months and three months ended June 30, 2009 and 2008 are as follows:

| (In thousands)  | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | June 30,<br>2009   | June 30,<br>2008 | June 30,<br>2009 | June 30,<br>2008 |
| Unrealized holding gains (losses) on available for sale securities          | \$ 1,644           | \$ (2,259 )      | \$ 275           | \$ (4,100 )      |
| Less: Reclassification adjustment for (gains) losses realized in net income | (339 )             | 10               | (518 )           | (16 )            |
| Less: Reclassification adjustment for other than temporary impairment       | 60                 | 83               | 136              | 265              |
| Net unrealized gains (losses)   | 1,365              | (2,166 )         | (107 )           | (3,851 )         |
| Tax effect  | 465                | 736              | (36 )            | (1,309 )         |
| Other comprehensive income (loss)   | \$ 900             | \$ (1,430 )      | \$ (71 )         | \$ (2,542 )      |

#### NOTE 5. STOCK-BASED COMPENSATION

As of June 30, 2009, all stock options were fully vested and there are no unrecognized compensation costs related to stock options. For the six month periods ending June 30, 2009 and 2008, respectively, there were no stock options granted.

#### NOTE 6. GUARANTEES

The Company does not issue any guarantees that would require liability recognition or disclosure, other than standby letters of credit. Outstanding letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. The Company had \$11.443 million of standby letters of credit as of June 30, 2009. The Bank uses the same credit policies in making conditional obligations as it does for on-balance sheet instruments.

The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these letters of credit as deemed necessary. The maximum undiscounted exposure related to these commitments at June 30, 2009 was \$11.443 million and the approximate value of underlying collateral upon liquidation, that would be expected to cover this maximum potential exposure, was \$10.368 million.



## NOTE 7. NEW ACCOUNTING STANDARDS

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP FAS 157-4). FASB Statement 157, Fair Value Measurements, defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP FAS 157-4 provides additional guidance on determining when the volume and level of activity for the asset or liability has significantly decreased. The FSP also includes guidance on identifying circumstances when a transaction may not be considered orderly.

FSP FAS 157-4 provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with Statement 157.

This FSP clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The FSP provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

This FSP is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted this FSP for the quarter ended June 30, 2009. This FSP had no impact on the Company's consolidated financial statements upon adoption, although additional disclosures were required and are included in Note 8.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (FSP FAS 115-2 and FAS 124-2). FSP FAS 115-2 and FAS 124-2 clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of the investment. Previously, this assessment required management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment. This change does not affect the need to forecast recovery of the value of the security through either cash flows or market price.

In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, FSP FAS 115-2 and FAS 124-2 changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.



This FSP is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted this FSP for the quarter ended June 30, 2009. This FSP had no impact on the Company's consolidated financial statements upon adoption.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 amends FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in summarized financial information at interim reporting periods.

This FSP is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted this FSP for the quarter ended June 30, 2009. This FSP had no impact on the Company's consolidated financial statements upon adoption, although additional disclosures were required and are included in Note 8.

In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140. This statement prescribes the information that a reporting entity must provide in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor's continuing involvement in transferred financial assets. Specifically, among other aspects, SFAS 166 amends Statement of Financial Standard No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, or SFAS 140, by removing the concept of a qualifying special-purpose entity from SFAS 140 and removes the exception from applying FIN 46(R) to variable interest entities that are qualifying special-purpose entities. It also modifies the financial-components approach used in SFAS 140. SFAS 166 is effective for fiscal years beginning after November 15, 2009. The Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R). This statement amends FASB Interpretation No. 46, Consolidation of Variable Interest Entities (revised December 2003) — an interpretation of ARB No. 51, or FIN 46(R), to require an enterprise to determine whether it's variable interest or interests give it a controlling financial interest in a variable interest entity. The primary beneficiary of a variable interest entity is the enterprise that has both (1) the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. SFAS 167 also amends FIN 46(R) to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. SFAS 167 is effective for fiscal years beginning after November 15, 2009. The Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162. SFAS 168 replaces SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles, to establish the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with generally accepted accounting principles in the United States. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. We do not expect the adoption of this standard to have an impact on our financial position or results of operations.





## NOTE 8. FAIR VALUE MEASUREMENTS

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement No. 157, Fair Value Measurements (“SFAS 157”), which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements. The Company adopted SFAS 157 effective for its fiscal years beginning January 1, 2008.

In December 2007, the FASB issued FASB Staff Position 157-2, Effective Date of FASB Statement No. 157 (“FSP 157-2”). FSP 157-2 delays the effective date of SFAS 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. As such, the Company only partially adopted the provisions of SFAS 157 in 2008 and began to account and report for non-financial assets and liabilities in 2009. In October 2008, the FASB issued FASB Staff Position 157-3, Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active (“FSP 157-3”), to clarify the application of the provisions of SFAS 157 in an inactive market and how an entity would determine fair value in an inactive market. The adoption of SFAS 157 and FSP 157-3 had no impact on the amounts reported in the consolidated financial statements.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS 157 are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset’s or liability’s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2009 and December 31, 2008 are as follows:

| Description<br>(In Thousands) | (Level 1)<br>Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets |            | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
|-------------------------------|--|------------|---|--|
|                               | June 30, 2009 Securities available for sale                                      | \$ 103,349 | \$ 1,194  | \$ 102,155   |
|                               | \$ 110,247   | \$ 1,010   | \$ 108,146  | \$ 1,091   |

December 31, 2008 Securities available  
for sale

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The following table presents a roll forward of the securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six months ended June 30, 2009:

(In Thousands)

|  |          |
|--|----------|
| Beginning balance, January 1                         | \$ 1,091 |
| Exchange of common stock available for sale security | (1,091 ) |
| Ending balance, June 30                              | \$ 0     |

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2009 and December 31, 2008 are as follows:

| Description<br>(In Thousands)             | (Level 1)<br>Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets |          |      |      | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
|---|---|----------|------|------|---|--|
|   | June 30, 2009 Impaired loans  | \$ 2,137 | \$ 0 | \$ 0 | \$ 0  | \$ 2,137   |
| June 30, 2009 Other real estate owned     | \$ 5,440  | \$ 0     | \$ 0 | \$ 0 | \$ 5,440  |  |
| December 31, 2008 Impaired loans          | \$ 2,168  | \$ 0     | \$ 0 | \$ 0 | \$ 2,168  |  |
| December 31, 2008 Other real estate owned | \$ 5,171  | \$ 0     | \$ 0 | \$ 0 | \$ 5,171  |  |

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at June 30, 2009:

Cash and Cash Equivalents (Carried at Cost)

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair values.

#### Securities

The fair value of securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) were used to support fair values of certain Level 3 investments.

#### Loans Receivable (Carried at Cost)

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

#### Impaired Loans (Generally Carried at Fair Value)

Impaired loans are those that are accounted for under FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan ("SFAS 114"), in which the Bank has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances of \$2,369,000, net of a valuation allowance of \$232,000 recorded during the six months ended June 30, 2009. There was a net decrease in the provision for loan losses of \$392,000.

#### Other Real Estate Owned

Other real estate owned is recorded at fair value, net of estimated selling costs, at the date of foreclosure. Subsequent declines in the recorded value of the property prior to its disposal is included in other expense.

#### Servicing Rights (Carried at Lower of Cost or Fair Value)

The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation incorporation assumptions that market participants would use in estimating future net servicing income. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness. Mortgage servicing rights of \$242,802 are included in other assets as of June 30, 2009.

#### Restricted Investment in Bank Stock (Carried at Cost)

The carrying amount of restricted investment in bank stock approximates fair value, and considers the limited marketability of such securities.

#### Accrued Interest Receivable and Payable (Carried at Cost)

The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

**Deposit Liabilities (Carried at Cost)**

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

**Short-Term Borrowings (Carried at Cost)**

The carrying amounts of short-term borrowings approximate their fair values.

**Long-Term Debt (Carried at Cost)**

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

**Off-Balance Sheet Financial Instruments (Disclosed at Cost)**

Fair values for the Company's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The estimated fair values of the Company's financial instruments were as follows at June 30, 2009 (in thousands):

|  | June 30, 2009      |            |
|--|--------------------|------------|
|  | Carrying<br>Amount | Fair Value |
| Financial assets:                          |                    |            |
| Cash and cash equivalents                  | \$ 13,254          | \$ 13,254  |
| Securities available-for-sale              | 103,349            | 103,349    |
| Loans receivable, net of allowance         | 315,641            | 344,305    |
| Accrued interest receivable                | 2,733              | 2,733      |
| Financial liabilities:                     |                    |            |
| Deposits                                   | 360,376            | 361,269    |
| Short-term borrowings                      | 20,022             | 20,022     |
| Long-term borrowings                       | 39,191             | 39,675     |
| Accrued interest payable                   | 438                | 438        |
| Off-balance sheet items:                   |                    |            |
| Commitments to giant loans                 | -                  | -          |
| Unfunded commitments under lines of credit | -                  | -          |
| Standby letters of credit                  | -                  | -          |



NOTE 9. EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

In response to recent unprecedented market turmoil, the Emergency Economic Stabilization Act ("EESA") was enacted on October 3, 2008. EESA authorizes the Secretary of the Treasury to purchase up to \$700 billion in troubled assets from financial institutions under the Troubled Asset Relief Program or TARP. Troubled assets include residential or commercial mortgages and related instruments originated prior to March 14, 2008 and any other financial instrument that the Secretary determines, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, the purchase of which is necessary to promote financial stability. If the Secretary exercises his authority under TARP, EESA directs the Secretary of Treasury to establish a program to guarantee troubled assets originated or issued prior to March 14, 2008. The Secretary is authorized to purchase up to \$250 billion in troubled assets immediately and up to \$350 billion upon certification by the President that such authority is needed. The Secretary's authority will be increased to \$700 billion if the President submits a written report to Congress detailing the Secretary's plans to use such authority unless Congress passes a joint resolution disapproving such amount within 15 days after receipt of the report. The Secretary's authority under TARP expires on December 31, 2009 unless the Secretary certifies to Congress that extension is necessary provided that his authority may not be extended beyond October 3, 2010.

Institutions selling assets under TARP will be required to issue warrants for common or preferred stock or senior debt to the Secretary. If the Secretary purchases troubled assets directly from an institution without a bidding process and acquires a meaningful equity or debt position in the institution as a result or acquires more than \$300 million in troubled assets from an institution regardless of method, the institution will be required to meet certain standards for executive compensation and corporate governance, including a prohibition against incentives to take unnecessary and excessive risks, recovery of bonuses paid to senior executives based on materially inaccurate earnings or other statements and a prohibition against agreements for the payment of golden parachutes. Institutions that sell more than \$300 million in assets under TARP auctions will not be entitled to a tax deduction for compensation in excess of \$500,000 paid to its chief executive or chief financial official or any its other three most highly compensated officers. In addition, any severance paid to such officers for involuntary termination or termination in connection with a bankruptcy or receivership will be subject to the golden parachute rules under the Internal Revenue Code.

EESA increases the maximum deposit insurance amount up to \$250,000 until December 31, 2009 and removes the statutory limits on the FDIC's ability to borrow from the Treasury during this period. The FDIC may not take the temporary increase in deposit insurance coverage into account when setting assessments. EESA allows financial institutions to treat any loss on the preferred stock of the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation as an ordinary loss for tax purposes.

Pursuant to his authority under EESA, the Secretary of the Treasury has created the TARP Capital Purchase Plan under which the Treasury Department will invest up to \$250 billion in senior preferred stock of U.S. banks and savings associations or their holding companies. Qualifying financial institutions may issue senior preferred stock with a value equal to not less than 1% of risk-weighted assets and not more than the lesser of \$25 billion or 3% of risk-weighted assets. The senior preferred stock will pay dividends at the rate of 5% per annum until the fifth anniversary of the investment and thereafter at the rate of 9% per annum. The senior preferred stock may not be redeemed for three years except with the proceeds from an offering of common stock or preferred stock qualifying as Tier 1 capital in an amount equal to not less than 25% of the amount of the senior preferred. After three years, the senior preferred may be redeemed at any time in whole or in part by the financial institution. No dividends may be paid on common stock unless dividends have been paid on the senior preferred stock.



Until the third anniversary of the issuance of the senior preferred, the consent of the U.S. Treasury will be required for any increase in the dividends on the common stock or for any stock repurchases unless the senior preferred has been redeemed in its entirety or the Treasury has transferred the senior preferred to third parties. The senior preferred will not have voting rights other than the right to vote as a class on the issuance of any preferred stock ranking senior, any change in its terms or any merger, exchange or similar transaction that would adversely affect its rights. The senior preferred will also have the right to elect two directors if dividends have not been paid for six periods. The senior preferred will be freely transferable and participating institutions will be required to file a shelf registration statement covering the senior preferred. The issuing institution must grant the Treasury piggyback registration rights. Prior to issuance, the financial institution and its senior executive officers must modify or terminate all benefit plans and arrangements to comply with EESA. Senior executives must also waive any claims against the Department of Treasury.

In connection with the issuance of the senior preferred, participating institutions must issue to the Secretary immediately exercisable 10-year warrants to purchase common stock with an aggregate market price equal to 15% of the amount of senior preferred. The exercise price of the warrants will equal the market price of the common stock on the date of the investment. The Secretary may only exercise or transfer one-half of the warrants prior to the earlier of December 31, 2009 or the date the issuing financial institution has received proceeds equal to the senior preferred investment from one or more offerings of common or preferred stock qualifying as Tier 1 capital. The Secretary will not exercise voting rights with respect to any shares of common stock acquired through exercise of the warrants. The financial institution must file a shelf registration statement covering the warrants and underlying common stock as soon as practicable after issuance and grant piggyback registration rights. The number of warrants will be reduced by one-half if the financial institution raises capital equal to the amount of the senior preferred through one or more offerings of common stock or preferred stock qualifying as Tier 1 capital. If the financial institution does not have sufficient authorized shares of common stock available to satisfy the warrants or their issuance otherwise requires shareholder approval, the financial institution must call a meeting of shareholders for that purpose as soon as practicable after the date of investment. The exercise price of the warrants will be reduced by 15% for each six months that lapse before shareholder approval subject to a maximum reduction of 45%.

The Company had a filing deadline of November 14, 2008 to participate in the Capital Purchase Plan. The Company elected not to participate in the plan.

#### NOTE 10. FEDERAL DEPOSIT INSURANCE

The Company has experienced significant increases in the cost of federal deposit insurance from previous year's levels of five to seven basis points. The FDIC has recently increased the assessment rate for the most highly rated institutions to between 12 and 16 basis points starting with the first quarter of 2009 and to between 10 and 14 basis points thereafter. The result is an assessment rate being paid by the Bank of just under 14 basis points. Assessment rates could be further increased if an institution's FHLB advances exceed 15% of deposits. The FDIC has also established a program under which it fully guarantees all non-interest bearing transaction accounts and senior unsecured debt of a bank or its holding company. Institutions that did not opt out of the program by November 14, 2008 have been assessed ten basis points for non-interest bearing transaction account balances in excess of \$250,000 with the first quarter assessments for 2009 and 75 basis points of the amount of debt issued. Lastly, the FDIC has issued a final rule regarding the special assessment for June 30, 2009. The special assessment will be 5 basis points applied to the Bank's assets, net of Tier 1 capital. The assessment is for all insured institutions. The special assessment is payable September 30, 2009. The Company has accrued \$210,000 related to this special assessment for the quarter ending June 30, 2009.



Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the consolidated financial statements of the Corporation is presented to provide insight into management's assessment of financial results. The Corporation's subsidiaries, Peoples National Bank and Peoples Advisors, LLC, provide financial services to individuals and businesses within the Bank's primary market area made up of Susquehanna, Wyoming and Northern Lackawanna Counties in Pennsylvania, and Broome County in New York. The Bank is a member of the Federal Reserve System and subject to regulation, supervision, and examination by the Office of the Comptroller of the Currency. Advisors is a member of the National Association of Securities Dealers (NASD), which also acts as the primary regulator for Advisors. Peoples Financial Leasing, LLC is a subsidiary of the Bank and provides employee leasing services to the Bank. Peoples Investment Holdings, LLC is also a subsidiary of the Bank and its main activities are the maintenance and management of its intangible investments and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware. Likewise, Peoples Financial Capital Corporation is a subsidiary of the Company and its main activities are the maintenance and management of its intangible investments and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware.

CAUTIONARY STATEMENT CONCERNING FORWARD LOOKING INFORMATION

Except for historical information, this Report may be deemed to contain "forward looking" information. Examples of forward looking information may include, but are not limited to, (a) projections of or statements regarding future earnings, interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, (c) statements of future economic performance, and (d) statements of assumptions, such as economic conditions in the market areas served by the Corporation and the Bank, underlying other statements and statements about the Corporation and the Bank or their respective businesses. Such forward looking information can be identified by the use of forward looking terminology such as "believes," "expects," "may," "intends," "will," "should," "anticipates," or the use of any of the foregoing or other variations thereon or comparable terminology, or by discussion of strategy. No assurance can be given that the future results covered by the forward looking information will be achieved. Such statements are subject to risks, uncertainties, and other factors which could cause actual results to differ materially from future results expressed or implied by such forward looking information. Important factors that could impact operating results include, but are not limited to, (i) the effects of changing economic conditions in both the market areas served by the Corporation and the Bank and nationally, (ii) credit risks of commercial, real estate, consumer and other lending activities, (iii) significant changes in interest rates, (iv) changes in federal and state banking laws and regulations which could affect operations, (v) funding costs, and (vi) other external developments which could materially affect business and operations.

## CRITICAL ACCOUNTING POLICIES

Disclosure of the Company's significant accounting policies is included in Note 1 to the consolidated financial statements of the Company's Annual Report on Form 10-K for the year ended December 31, 2008. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by Management. Additional information is contained on page 32 of this report for the provision and allowance for loan losses.

## OVERVIEW

Net income for the six months ended June 30, 2009 decreased 11.06% to \$2.774 million as compared to \$3.119 million for the same period in 2008. Diluted earnings per share decreased 11.00% to \$0.89 per share for the first half of 2009 from \$1.00 per share in the same six month period in 2008. At June 30, 2009, the Company had total assets of \$462.606 million, net loans of \$315.641 million, and total deposits of \$360.376 million.

## FINANCIAL CONDITION

### Cash and Cash Equivalents:

At June 30, 2009, cash, federal funds sold, and deposits with other banks totaled \$13.254 million as compared to \$18.533 million on December 31, 2008. The decrease over the first six months of 2009 has been directly attributable to the decrease in federal funds sold. As total deposit balances have decreased by \$10.892 million in the first half of 2009, federal funds sold have decreased \$4.980 million.

Management believes the liquidity needs of the Corporation are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, and the portion of the securities and loan portfolios that mature within one year. The current sources of funds will enable the Corporation to meet all its cash obligations as they come due.

### Securities:

Securities totaled \$103.349 million on June 30, 2009, decreasing by \$6.898 million, or 6.26% from the December 31, 2008 total of \$110.247 million.

The total securities portfolio is held as available for sale. This strategy was implemented in 1995 to provide more flexibility in using the investment portfolio for liquidity purposes as well as providing more flexibility in selling when market opportunities occur.

Securities available for sale are accounted for at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income component of stockholders' equity. The carrying value of securities, as of June 30, 2009, included an unrealized loss of \$7.312 million reflected as accumulated other comprehensive loss of \$4.826 million in stockholders' equity, net of deferred income taxes of \$2.486 million. This compares to an unrealized loss of \$7.205 million at December 31, 2008 reflected as accumulated other comprehensive loss of \$4.755 million, net of deferred income taxes of \$2.450 million. The majority of the unrealized losses reflect changes in interest rates subsequent to the acquisition of specific securities and management believes that these unrealized losses represent a temporary impairment of those securities. As long term rates increase, the underlying value of securities owned by the Company decrease, creating an unrealized loss. The Company does not intend to sell these securities nor is it likely they will be required to sell the security before recovery of its amortized cost basis. The Company has the intent and ability to hold such securities until maturity or market price recovery. Management

believes that the unrealized losses represent temporary impairment of the securities.

Management monitors the earnings performance and effectiveness of liquidity of the securities portfolio on a monthly basis through the Asset/Liability Committee (“ALCO”). The ALCO also reviews and manages interest rate risk for the Corporation. Through active balance sheet management and analysis of the securities portfolio, the Corporation maintains sufficient liquidity to satisfy depositor requirements and various credit needs of its customers.

Loans:

Net loans increased \$2.035 million, or 0.65%, to \$315.641 million as of June 30, 2009 from \$313.606 million as of December 31, 2008. Of the loan growth experienced in the second quarter of 2009, the most significant increase was in commercial loans at \$3.083 million, or 1.73%, to \$181.425 million as of June 30, 2009 compared to \$178.342 million at year-end December 31, 2008. Residential real estate mortgages decreased \$2.250 million, or 1.86%, to \$118.563 million as of June 30, 2009 compared to \$120.813 million as of December 31, 2008. Consumer loans increased the most in percentage terms at 6.55%, or \$1.112 million, to \$18.100 million as of June 30, 2009 compared to \$16.988 million at year-end December 31, 2008.

Maintaining the loan to deposit ratio is a goal of the Bank, but loan quality is always considered in this effort. Management has continued its efforts to create good underwriting standards for both commercial and consumer credit. Most commercial lending is done primarily with locally owned small businesses.

Deposits:

Deposits are attracted from within the Bank’s primary market area through the offering of various deposit instruments including NOW accounts, money market accounts, savings accounts, certificates of deposit, and IRA’s. During the six month period ended June 30, 2009, total deposits decreased by \$10.892 million, or 2.93%, to \$360.376 million compared to \$371.268 million as of December 31, 2008. Time deposits decreased by \$72.885 million, or 44.36%, to \$91.420 million when compared to year end December 31, 2008 at \$164.305 million. Other core deposit relationships increased or decreased as follows; demand deposits were up \$9.836 million, or 17.78%, to \$65.160 million when compared to \$55.324 million at December 31, 2008. Interest-bearing checking deposits were also up \$3.933 million, or 12.99%, to \$34.209 million compared to \$30.276 million as of December 31, 2008. Money market deposit accounts were down \$2.477 million, or 7.23%, to \$31.780 million compared to \$34.257 million as of December 31, 2008. And finally, savings deposits were up \$50.701 million, or 58.21%, to \$137.807 million when compared to \$87.106 million at December 31, 2008.

The trend in the first half of 2009 is expected due to the nature of those deposits affected. The current economic climate has induced consumers to seek safe alternatives in which to invest their money. Short term and core deposit rates have remained flat while at the same time rates offered on certificates of deposit have decreased compared to the same time period in 2008. As such, savings deposits offer consumers a competitive interest rate while at the same time offering the relative safety offered by a commercial bank and the expanded \$250,000 FDIC insurance.

**Borrowings:**

The Bank utilizes borrowings as a source of funds for its asset/liability management. Advances are available from the Federal Home Loan Bank (FHLB) provided certain standards related to credit worthiness have been met. Repurchase and term agreements are also available from the FHLB.

Total short-term borrowings at June 30, 2009 were \$20.022 million as compared to \$18.432 million as of December 31, 2008, an increase of \$1.590 million, or 8.63%. Long-term borrowings were \$39.191 million as of June 30, 2009 compared to \$39.691 million as of December 31, 2008, a decrease of \$500 thousand, or 1.26%. The decrease in long-term borrowings includes the contractual principal payments to the FHLB.

**Accrued Interest Payable:**

Accrued interest payable decreased \$1.211 million, or 73.44%, from December 31, 2008 to June 30, 2009 due to the decrease in the balance of interest bearing deposits as well as the offered rates on deposits. Also, the cost of borrowings decreased significantly over the same period. See the interest rates and interest differential table on page 31.

**Capital:**

The adequacy of the Company's capital is reviewed on an ongoing basis with reference to the size, composition and quality of the Company's resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings. As of June 30, 2009, regulatory capital to total average assets was 8.97% as compared to 8.45% on December 31, 2008. The Company repurchases its stock in the open market, or from individuals as warranted, to leverage the capital account and to provide stock for its stock option plan and dividend reinvestment plan. In the six months ended June 30, 2009 however, the Company did not purchase any additional shares for the treasury.

The Company has complied with the standards of capital adequacy mandated by the banking regulators. The bank regulators have established "risk-based" capital requirements designed to measure capital adequacy. Risk-based capital ratios reflect the relative risks of various assets the banks hold in their portfolios. A weight category of either 0% (lowest risk asset), 20%, 50%, or 100% (highest risk assets) is assigned to each asset on the balance sheet. Capital is being maintained in compliance with risk-based capital guidelines. The Company's Tier 1 capital to risk weighted asset ratio was 11.49% and the total capital ratio to risk weighted asset ratio was 12.31% at June 30, 2009. The Company is deemed to be well-capitalized under regulatory standards.

**Liquidity:**

Liquidity measures an organization's ability to meet cash obligations as they come due. The consolidated statements of cash flows presented in the accompanying consolidated financial statements included in Part I of this Form 10-Q provide analysis of the Company's cash and cash equivalents. Additionally, management considers that portion of the loan and investment portfolio that matures within one year as part of the Company's liquid assets.

The liquidity of the Company is reflected in its capacity to have sufficient amounts of cash available to fund the needs of customer withdrawal requests, accommodate loan demand, and maintain regulatory reserve requirements; that is to conduct banking business. Additional liquidity is obtained by either increasing liabilities or by decreasing assets. The primary source for increasing liabilities is the generation of additional deposit accounts, which are managed through our system of branches. In addition, payments on existing loans or securities available-for-sale can generate additional liquidity. Other sources include income from operations, decreases in federal funds sold or interest-bearing deposits in other banks, securities sold under agreements to repurchase, and borrowings from the Federal Home Loan Bank (FHLB). As of June 30, 2009, the Bank had a borrowing capacity from the Federal Home Loan Bank of approximately \$153,100,000. In 2008, significant increases in deposits limited the Company's dependence on overnight borrowings at the FHLB and provided the majority of additional cash with operating activities also contributing to liquidity. The additional deposits were used primarily to grant loans to customers. In 2009, overall deposits have decreased as many of the certificates of deposits that contributed to the dramatic deposit growth in 2008 have not renewed. This decrease however has not resulted in an increased reliance on the FHLB for funding needs.

The Company feels that it offers a variety of attractive deposit products at competitive rates that will mitigate significant runoff in deposits from occurring. One such product is the certificate of savings product which acts as a hybrid between a core savings product and a short term certificate of deposit. This deposit product offers an interest rate that far outweighs any comparable savings product on the market and a quarterly limit placed on customer withdrawals which provide stability in funding to the Company. This account has proven to be a deposit leader in the past and the Company will rely on it to provide a source of funds. Beyond its own product line up, the Company also has available to it open lines of credit at the FHLB with current availability of approximately \$93,887,000, Atlantic Central Bankers Bank (ACBB) in the amount of \$7,000,000 and the Federal Reserve Bank of Philadelphia (FRB) that amount to \$16,700,000. While the FHLB has been an inexpensive source of funds in the past, liquidity concerns surrounding the FHLB have prompted the Company to explore additional funding options at the FRB. Collateral standards of the FRB make it feasible to increase available lines and open the Company up to yet another source of funding liquidity. This will be investigated further and implemented in 2009.

The ALCO addresses the liquidity needs of the Bank to see that sufficient funds are available to meet credit demands and deposit withdrawals, as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.

#### Off-Balance Sheet Arrangements:

The Company's consolidated financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist primarily of commitments to grant new loans, unfunded commitments of existing loans and letters of credit made under the same standards as on-balance sheet instruments. Unused commitments on June 30, 2009 totaled \$52.927 million, which consisted of \$32.514 million in unfunded commitments of existing loans, \$8.970 million to grant new loans and \$11.443 million in letters of credit. Due to fixed maturity dates and specified conditions within these instruments, many will expire without being drawn upon. Management believes that amounts actually drawn upon can be funded in the normal course of operations and therefore, do not represent a significant liquidity risk to the Company.



Interest Rate Sensitivity:

The management of interest rate sensitivity seeks to avoid fluctuating net interest margins and to provide consistent net interest income through periods of changing interest rates.

The Company's risk of loss arising from adverse changes in the fair value of financial instruments, or market risk, is composed primarily of interest rate risk. The primary objective of the Company's asset/liability management activities is to maximize net interest income while maintaining acceptable levels of interest rate risk. The Company's ALCO is responsible for establishing policies to limit exposure to interest rate risk, and to ensure procedures are established to monitor compliance with those policies. The guidelines established by ALCO are reviewed by the Company's Board of Directors.

The tools used to monitor sensitivity are the Statement of Interest Sensitivity Gap and the Interest Rate Shock Analysis. The Bank uses a software model to measure and to keep track. In addition, an outside source does a quarterly analysis to make sure our internal analysis is current and correct. The Statement of Interest Sensitivity Gap is a good assessment of current position and is a very useful tool for the ALCO in performing its job. This report is monitored in an effort to "match" maturities or re-pricing opportunities of assets and liabilities, in order to attain the maximum interest within risk tolerance policy guidelines. The Statement does, although, have inherent limitations in that certain assets and liabilities may react to changes in interest rates in different ways, with some categories reacting in advance of changes and some lagging behind the changes. In addition, there are estimates used in determining the actual propensity to change of certain items, such as deposits without maturities.

The following table sets forth the Company's interest sensitivity analysis as of June 30, 2009:

### INTEREST RATE SENSITIVITY ANALYSIS

(Dollars in thousands)

Maturity or Re-pricing In:

|  | 3 Months     | 3-6 Months   | 6-12<br>Months | 1-5 Years   | Over 5<br>Years |
|--|--------------|--------------|----------------|-------------|-----------------|
| <b>RATE SENSITIVE ASSETS</b>             |              |              |                |             |                 |
| Interest bearing deposits in other banks | \$769        | \$0          | \$0            | \$0         | \$0             |
| Federal funds sold                       | 5,597        | 0            | 0              | 0           | 0               |
| Securities                               | 4,628        | 3,534        | 5,736          | 20,327      | 69,124          |
| Loans                                    | 39,838       | 19,716       | 44,560         | 161,458     | 50,069          |
| Total rate sensitive assets              | 50,832       | 23,250       | 50,296         | 181,785     | 119,193         |
| Cumulative rate sensitive assets         | \$50,832     | \$74,082     | \$124,378      | \$306,163   | \$425,356       |
| <b>RATE SENSITIVE LIABILITIES</b>        |              |              |                |             |                 |
| Interest bearing checking                | \$34,209     | \$0          | \$0            | \$0         | \$0             |
| Money market deposits                    | 31,780       | 0            | 0              | 0           | 0               |
| Regular savings                          | 137,807      | 0            | 0              | 0           | 0               |
| CDs and IRAs                             | 29,816       | 16,455       | 11,637         | 32,029      | 1,483           |
| Short-term borrowings                    | 20,022       | 0            | 0              | 0           | 0               |
| Long-term borrowings                     | 219          | 222          | 3,181          | 23,782      | 11,787          |
| Total rate sensitive liabilities         | 253,853      | 16,677       | 14,818         | 55,811      | 13,270          |
| Cumulative rate sensitive liabilities    | \$253,853    | \$270,530    | \$285,348      | \$341,159   | \$354,429       |
| Period gap                               | \$(203,021 ) | \$6,573      | \$35,478       | \$125,974   | \$105,923       |
| Cumulative gap                           | \$(203,021 ) | \$(196,448 ) | \$(160,670 )   | \$(34,996 ) | \$70,927        |
| Cumulative RSA to RSL                    | 20.15 %      | 27.50 %      | 43.70 %        | 89.84 %     | 120.10 %        |
| Cumulative gap to total assets           | (43.82 )%    | (42.40 )%    | (34.73 )%      | (7.50 )%    | 15.40 %         |

### RESULTS OF OPERATIONS

Net Interest Income:

For the three months ended June 30, 2009, total interest income decreased by \$200 thousand, or 3.17%, to \$6.108 million as compared to \$6.308 million for the three months ended June 30, 2008. This decrease was primarily due to lower rates. The yield earned on loans for the three months ended June 30, 2009 was 6.29% compared to a 6.82% yield on loans for the quarter ended June 30, 2008. Conversely, average earning assets increased to \$426.965 million for the three months ended June 30, 2009 as compared to \$408.926 million for the three months ended June 30, 2008 while average loans increased to \$319.052 million for the quarter ended June 30, 2009 as compared to \$298.412 million for the same period in 2008. This would indicate the reduction in interest was interest rate driven when comparing the two periods. The resulting interest earned on loans was \$4.880 million for the three month period ended June 30, 2009 compared to \$4.927 million for the same period in 2008, a decrease of \$47 thousand, or 0.95%. The overall yield on earning assets, on a fully tax equivalent basis, decreased for the three months ended June 30, 2009 to 6.10% as compared to 6.53% for the three months ended June 30, 2008. This has been due to lower market yields available for investment.



For the six months ended June 30, 2009, total interest income decreased by \$427 thousand, or 3.36%, to \$12.292 million as compared to \$12.719 million for the six months ended June 30, 2008. This decrease was also primarily due to lower rates. The yield earned on loans for the six months ended June 30, 2009 was 6.31% compared to a 6.96% yield on loans for the six months ended June 30, 2008. As with the quarterly discussion, average earning assets increased for the six months ended June 30, 2009 to \$432.313 million as compared to \$407.354 million for the six months ended June 30, 2008. Average total loans increased to \$318.438 million for the six months ended June 30, 2009 as compared to \$295.169 million for the six months ended June 30, 2008. The resulting interest earned on loans was \$9.724 million for the six-month period ended June 30, 2009 compared to \$9.949 million for the same period in 2008, a decrease of \$225 thousand, or 2.26%. The overall yield on earning assets, on a tax equivalent basis, decreased for the six months ended June 30, 2009 to 6.09% as compared to 6.61% for the six months ended June 30, 2008.

Total interest expense decreased by \$455 thousand, or 21.18%, to \$1.693 million for the three months ended June 30, 2009 from \$2.148 million for the three months ended June 30, 2008. This decrease was attributable to the decrease in the cost of funds. The cost of funds decreased to 1.92% for the three months ended June 30, 2009 as compared to 2.56% for the second quarter of 2008. Average interest bearing liabilities on the other hand increased to \$353.129 million for the three months ended June 30, 2009 as compared to \$337.383 million for the three months ended June 30, 2008. This increase was due to the increase in average savings deposits. Average savings deposits increased to \$127.190 million for the three month period ended June 30, 2009 as compared to \$96.542 million for the same period in 2008. This increase occurred at the same time that average time deposit balances were decreasing. Average time deposits decreased to \$99.834 million for the three month period ended June 30, 2009 as compared to \$119.247 million for the same period in 2008. This was due to the low rate environment and the resulting rates offered for time deposits.

Total interest expense decreased by \$758 thousand, or 16.54%, to \$3.824 million for the six months ended June 30, 2009 from \$4.582 million for the six months ended June 30, 2008. As with the quarterly interest expense, this decrease was primarily attributable to the decrease in the cost of funds, which decreased to 2.14% for the six month period ended June 30, 2009 as compared to 2.74% for the same period in 2008. Offsetting the decrease in the cost of funds was the increase to average interest bearing liabilities to \$360.477 million for the six months ended June 30, 2009 as compared to \$335.757 million for the six months ended June 30, 2008. The year-to-date increase in average interest bearing liabilities was also due to the increase in average savings deposits. Average savings deposits increased to \$112.037 million for the six month period ended June 30, 2009 when compared to \$97.048 million for the six month period ended June 30, 2008.

Net interest income increased by \$255 thousand, or 6.13%, to \$4.415 million for the three months ended June 30, 2009 from \$4.160 million for the three months ended June 30, 2008. The Bank's net interest spread increased to 4.18% for the three months ended June 30, 2009 from 3.97% for the three months ended June 30, 2008 on a fully tax equivalent basis. The net interest margin increased to 4.51% for the three month period ended June 30, 2009 from 4.42% for the three month period ended June 30, 2008 on a fully tax equivalent basis. The yield curve has become increasingly steep since the Federal Reserve began their process of injecting liquidity into the financial markets through the implementation of lower overnight and discount rates as well as the treasury purchases aimed at keeping borrowing rates low. The effect this has had on short-term rates is that overnight federal funds rates are near 0%. The preceding discussion is an indication of the results of how lower funding costs have affected the company. As deposit liability rates are affected by the short end of the yield curve and loan and securities rates tend to follow the long end of the yield curve, the result has been an increase in net interest margin between the two periods compared.

Net interest income increased by \$331 thousand, or 4.07%, to \$8.468 million for the six months ended June 30, 2009 from \$8.137 million for the six months ended June 30, 2008. The Bank's net interest spread increased to 3.95% for the six months ended June 30, 2009 from 3.87% for the six months ended June 30, 2008 on a fully tax equivalent basis. The net interest margin actually has shown a slight decrease to 4.30% for the six month period ended June 30, 2009 from 4.35% for the six month period ended June 30, 2008 on a fully tax equivalent basis. The increase in net interest spread for the six months ended June 30, 2009 when compared to the six months ended June 30, 2008 is due to the steep yield curve discussed with the quarterly results.

Below are the tables which set forth average balances and corresponding yields for the three-month and six-month periods ended June 30, 2009, and June 30, 2008:

Distribution of Assets, Liabilities and Stockholders' Equity;  
Interest Rates and Interest Differential (quarter to date)

| (Dollars in thousands)                      | June 2009       |          | Three months ended    |                 | June 2008 |                       |      |   |
|---|-----------------|----------|-----------------------|-----------------|-----------|-----------------------|------|---|
|   | Average Balance | Interest | (2)<br>Yield/<br>Rate | Average Balance | Interest  | (2)<br>Yield/<br>Rate |      |   |
| <b>ASSETS</b>                               |                 |          |                       |                 |           |                       |      |   |
| <b>Loans</b>                                |                 |          |                       |                 |           |                       |      |   |
| Real estate                                 | \$ 119,998      | \$ 1,834 | 6.13                  | % \$ 116,271    | \$ 1,841  | 6.37                  | %    |   |
| Installment                                 | 17,500          | 268      | 6.14                  | % 17,087        | 323       | 7.60                  | %    |   |
| Commercial                                  | 159,096         | 2,533    | 6.39                  | % 140,940       | 2,493     | 7.11                  | %    |   |
| Tax exempt (1)                              | 21,966          | 235      | 6.50                  | % 23,652        | 259       | 6.67                  | %    |   |
| Other loans                                 | 492             | 10       | 8.15                  | % 462           | 11        | 9.58                  | %    |   |
| Total loans (1)                             | 319,052         | 4,880    | 6.29                  | % 298,412       | 4,927     | 6.82                  | %    |   |
| <b>Investment securities (AFS)</b>          |                 |          |                       |                 |           |                       |      |   |
| Taxable                                     | 51,885          | 693      | 5.36                  | % 69,525        | 974       | 5.63                  | %    |   |
| Non-taxable (1)                             | 52,624          | 530      | 6.12                  | % 39,807        | 401       | 6.13                  | %    |   |
| Total securities (1)                        | 104,509         | 1,223    | 5.74                  | % 109,332       | 1,375     | 5.82                  | %    |   |
| Time deposits with other banks              | 1,535           | 4        | 1.05                  | % 819           | 4         | 1.96                  | %    |   |
| Fed funds sold                              | 1,869           | 1        | 0.21                  | % 363           | 2         | 2.22                  | %    |   |
| Total earning assets (1)                    | 426,965         | 6,108    | 6.10                  | % 408,926       | 6,308     | 6.53                  | %    |   |
| Less: allowance for loan losses             | (2,841 )        |          |                       | (2,517 )        |           |                       |      |   |
| Cash and due from banks                     | 5,991           |          |                       | 6,946           |           |                       |      |   |
| Premises and equipment, net                 | 6,342           |          |                       | 6,016           |           |                       |      |   |
| Other assets                                | 22,476          |          |                       | 18,926          |           |                       |      |   |
| Total assets                                | \$ 458,933      |          |                       | \$ 438,297      |           |                       |      |   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                 |          |                       |                 |           |                       |      |   |
| <b>Deposits</b>                             |                 |          |                       |                 |           |                       |      |   |
| Interest bearing demand                     | \$ 32,913       | 69       | 0.84                  | % \$ 29,322     | 72        | 0.99                  | %    |   |
| Regular savings                             | 127,190         | 415      | 1.31                  | % 96,542        | 298       | 1.24                  | %    |   |
| Money market savings                        | 32,588          | 85       | 1.05                  | % 34,997        | 148       | 1.70                  | %    |   |
| Time  | 99,834          | 635      | 2.55                  | % 119,247       | 1,113     | 3.75                  | %    |   |
| Total interest bearing deposits             | 292,525         | 1,204    | 1.65                  | % 280,108       | 1,631     | 2.34                  | %    |   |
| Borrowings                                  | 60,604          | 489      | 3.24                  | % 57,275        | 517       | 3.63                  | %    |   |
| Total interest bearing                      | 353,129         | 1,693    | 1.92                  | % 337,383       | 2,148     | 2.56                  | %    |   |
| <b>Liabilities</b>                          |                 |          |                       |                 |           |                       |      |   |
| Net interest income (1)                     |                 | \$ 4,415 | 4.18                  | %               |           | \$ 4,160              | 3.97 | % |
| <b>Non-interest bearing</b>                 |                 |          |                       |                 |           |                       |      |   |
| Demand deposits                             | 64,658          |          |                       | 56,327          |           |                       |      |   |
| Accrued expenses and                        |                 |          |                       |                 |           |                       |      |   |
| Other liabilities                           | 2,614           |          |                       | 3,023           |           |                       |      |   |
| Stockholders' equity                        | 38,532          |          |                       | 41,564          |           |                       |      |   |
| Total liabilities and                       |                 |          |                       |                 |           |                       |      |   |
| Stockholders' equity                        | \$ 458,933      |          |                       | \$ 438,297      |           |                       |      |   |

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|                                 |      |   |      |   |
|---------------------------------|------|---|------|---|
| Interest income/earning assets  |      |   |      |   |
| (1)                             | 6.10 | % | 6.53 | % |
| Interest expense/earning assets | 1.59 | % | 2.11 | % |
| Net interest margin (1)         | 4.51 | % | 4.42 | % |

(1) Yields on tax exempt assets have been calculated on a fully tax equivalent basis assuming a tax rate of 34%.

(2) Yields and costs are based on a 365/91 annualization method.

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Distribution of Assets, Liabilities and Stockholders' Equity;  
Interest Rates and Interest Differential (year to date)

| (Dollars in thousands)                      | June 2009          |          | Six months ended      |   | June 2008          |          |                       |   |
|---|--------------------|----------|-----------------------|---|--------------------|----------|-----------------------|---|
|   | Average<br>Balance | Interest | (2)<br>Yield/<br>Rate |   | Average<br>Balance | Interest | (2)<br>Yield/<br>Rate |   |
| <b>ASSETS</b>                               |                    |          |                       |   |                    |          |                       |   |
| Loans                                       |                    |          |                       |   |                    |          |                       |   |
| Real estate                                 | \$120,716          | \$3,674  | 6.14                  | % | \$116,685          | \$3,763  | 6.49                  | % |
| Installment                                 | 17,292             | 557      | 6.50                  | % | 17,159             | 682      | 7.99                  | % |
| Commercial                                  | 158,075            | 5,007    | 6.39                  | % | 137,134            | 4,960    | 7.27                  | % |
| Tax exempt (1)                              | 21,873             | 466      | 6.51                  | % | 23,725             | 521      | 6.69                  | % |
| Other loans                                 | 482                | 20       | 8.37                  | % | 466                | 23       | 9.93                  | % |
| Total loans (1)                             | 318,438            | 9,724    | 6.31                  | % | 295,169            | 9,949    | 6.96                  | % |
| Investment securities (AFS)                 |                    |          |                       |   |                    |          |                       |   |
| Taxable                                     | 55,595             | 1,517    | 5.50                  | % | 70,514             | 1,940    | 5.53                  | % |
| Non-taxable (1)                             | 51,149             | 1,031    | 6.16                  | % | 40,680             | 818      | 6.12                  | % |
| Total securities (1)                        | 106,744            | 2,548    | 5.82                  | % | 111,194            | 2,758    | 5.75                  | % |
| Time deposits with other banks              | 1,753              | 12       | 1.38                  | % | 809                | 10       | 2.49                  | % |
| Fed funds sold                              | 5,378              | 8        | 0.30                  | % | 182                | 2        | 2.21                  | % |
| Total earning assets (1)                    | 432,313            | 12,292   | 6.09                  | % | 407,354            | 12,719   | 6.61                  | % |
| Less: allowance for loan losses             | (2,935             | )        |                       |   | (2,481             | )        |                       |   |
| Cash and due from banks                     | 5,859              |          |                       |   | 6,477              |          |                       |   |
| Premises and equipment, net                 | 6,757              |          |                       |   | 5,855              |          |                       |   |
| Other assets                                | 22,110             |          |                       |   | 18,335             |          |                       |   |
| Total assets                                | \$464,104          |          |                       |   | \$435,540          |          |                       |   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                    |          |                       |   |                    |          |                       |   |
| Deposits                                    |                    |          |                       |   |                    |          |                       |   |
| Interest bearing demand                     | \$31,614           | 132      | 0.84                  | % | \$27,483           | 137      | 1.00                  | % |
| Regular savings                             | 112,037            | 680      | 1.22                  | % | 97,048             | 713      | 1.48                  | % |
| Money market savings                        | 32,601             | 168      | 1.04                  | % | 34,631             | 346      | 2.01                  | % |
| Time  | 125,151            | 1,886    | 3.04                  | % | 116,998            | 2,295    | 3.94                  | % |
| Total interest bearing deposits             | 301,403            | 2,866    | 1.92                  | % | 276,160            | 3,491    | 2.54                  | % |
| Borrowings                                  | 59,074             | 958      | 3.27                  | % | 59,597             | 1,091    | 3.68                  | % |
| Total interest bearing                      | 360,477            | 3,824    | 2.14                  | % | 335,757            | 4,582    | 2.74                  | % |
| Liabilities                                 |                    |          |                       |   |                    |          |                       |   |
| Net interest income (1)                     |                    | \$8,468  | 3.95                  | % |                    | \$8,137  | 3.87                  | % |
| Non-interest bearing                        |                    |          |                       |   |                    |          |                       |   |
| Demand deposits                             | 61,712             |          |                       |   | 54,007             |          |                       |   |
| Accrued expenses and                        |                    |          |                       |   |                    |          |                       |   |
| Other liabilities                           | 3,206              |          |                       |   | 3,097              |          |                       |   |
| Stockholders' equity                        | 38,709             |          |                       |   | 42,679             |          |                       |   |
| Total liabilities and                       |                    |          |                       |   |                    |          |                       |   |
| Stockholders' equity                        | \$464,104          |          |                       |   | \$435,540          |          |                       |   |
| Interest income/earning assets              |                    |          |                       |   |                    |          |                       |   |
| (1)   |                    |          | 6.09                  | % |                    |          | 6.61                  | % |
| Interest expense/earning assets             |                    |          |                       |   |                    |          |                       |   |
|   |                    |          | 1.78                  | % |                    |          | 2.26                  | % |



|                         |      |   |      |   |
|-------------------------|------|---|------|---|
| Net interest margin (1) | 4.31 | % | 4.35 | % |
|-------------------------|------|---|------|---|

(1) Yields on tax exempt assets have been calculated on a fully tax equivalent basis assuming a tax rate of 34%.  
(2) Yields and costs are based on a 365/181 annualization method.

The following table shows the net interest income on a fully-tax-equivalent basis for the six month and three month periods ended June 30, 2009 and June 30, 2008.

## NET INTEREST INCOME

| (In thousands)                                   | Three Months Ended |                  | Six Months Ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | June 30,<br>2009   | June 30,<br>2008 | June 30,<br>2009 | June 30,<br>2008 |
| Total Interest Income                            | \$6,108            | \$6,308          | \$12,292         | \$12,719         |
| Tax Exempt Loans                                 | 121                | 133              | 240              | 268              |
| Non-Taxable Securities                           | 273                | 206              | 531              | 421              |
|  | 6,502              | 6,647            | 13,063           | 13,408           |
| Total Interest Expense                           | 1,693              | 2,148            | 3,824            | 4,582            |
| Net Interest Income (Fully Tax Equivalent Basis) | \$4,809            | \$4,499          | \$9,239          | \$8,826          |

## Provision for Loan Losses:

The provision for loan losses for the three months ended June 30, 2009 was \$1.040 million, an increase of \$905 thousand, or 670.37% over the same period in 2008. The increase in the provision for the second quarter of 2009 was due to a large commercial credit which had deteriorated to the point where the ultimate satisfaction of the credit was doubtful. The Company felt it prudent to charge the reserve and maintain satisfactory reserve levels.

The provision for loan losses for the six months ended June 30, 2009 was \$1.205 million, an increase of \$950 thousand, or 372.55% over the same period in 2008. This too was the result of the charge to reserves for the doubtful commercial credit discussed within the quarterly results. One of the Bank's main goals is to increase the loan to deposit ratio without jeopardizing loan quality. To reach its goal, management has continued its efforts to create strong underwriting standards for both commercial and consumer credit. The Bank's lending consists primarily of retail lending which includes single family residential mortgages and other consumer lending and commercial lending primarily to locally owned small businesses. The Bank has not participated in any sub-prime lending activity.

In the three month period ended June 30, 2009, charge-offs totaled \$1.294 million while net charge-offs totaled \$1.241 million as compared to \$11 thousand and \$2 thousand, respectively, for the same three month period in 2008.

In the six month period ended June 30, 2009, charge-offs totaled \$1.383 million while net charge-offs totaled \$1.279 million as compared to \$130 thousand and \$104 thousand, respectively, for the same six month period in 2008.

The variance between periods is due to the eventual charge off which was experienced in relation to the commercial credit discussed with the provision for loan loss. The charge off of this credit and increase in provisioning levels has allowed the Company to maintain adequate reserves.

Monthly, senior management uses a detailed analysis of the loan portfolio to determine loan loss reserve adequacy. The process considers all “problem loans” including classified, criticized, and monitored loans. Prior loan loss history and current market trends, both nationally and locally, are taken into consideration. A watch list of potential problem loans is maintained and monitored on a monthly basis by the Board of Directors. The Bank has not had, nor presently has, any foreign loans. Based upon this analysis, senior management has concluded that the allowance of loan losses is adequate.

#### Non-performing loans:

| (Dollars in Thousands)   | June 30, 2009 | December 31,<br>2008 |        |   |
|--|---------------|----------------------|--------|---|
| Non-accrual and restructured                                   | \$ 2,196      | \$                   | 4,871  |   |
| Loans past due 90 or more days, accruing interest              | 173           |                      | 245    |   |
| Total nonperforming loans                                      | 2,369         |                      | 5,116  |   |
| Foreclosed assets  | 5,440         |                      | 5,171  |   |
| Total nonperforming assets                                     | \$ 7,809      | \$                   | 10,287 |   |
| Nonperforming loans to total loans at period-end               | 0.74          | %                    | 1.62   | % |
| Nonperforming assets to period end loans and foreclosed assets | 2.41          | %                    | 3.20   | % |

#### Other Income:

Service charges and fees decreased 5.89%, or \$30 thousand, to \$479 thousand in the three months ended June 30, 2009, from \$509 thousand in the three months ended June 30, 2008. Net overdraft fees were \$263 thousand for the three months ended June 30, 2009 compared to \$311 thousand for the same period in 2008. This is a decrease of \$48,000, or 15.43% and it more than accounts for the variance in customer service fees between periods.

Service charges and fees decreased 5.01%, or \$49 thousand, to \$929 thousand in the six months ended June 30, 2009, from \$978 thousand in the six months ended June 30, 2008. Net overdraft fees were \$529 thousand for the six months ended June 30, 2009 compared to \$603 thousand for the same period in 2008. This is a decrease of \$74,000, or 12.27% and it more than accounts for the variance in customer service fees between periods.

Investment division income was \$119 thousand for the three month period ended June 30, 2009, an increase of \$43 thousand, or 56.58%, from \$76 thousand for the same period in 2008. The increase is expected under normal operating conditions as the investment division grows.

Investment division income was \$225 thousand for the six month period ended June 30, 2009, an increase of \$65 thousand, or 40.63%, from \$160 thousand for the same period in 2008. See previous discussion included in the quarterly results.

Earnings on investment in life insurance (BOLI) was \$82 thousand for the three month period ended June 30, 2009, compared to \$76 thousand for the three month period ended June 30, 2008, an increase of \$6 thousand, or 7.89%. This increase is not considered to be material.

Earnings on investment in life insurance (BOLI) were \$170 thousand for the six month period ended June 30, 2009, an increase of \$15 thousand, or 9.68%, when compared to \$155 thousand for the six month period ended June 30, 2008. Rate variances in the amount of \$7 thousand were recorded in January 2009 for the period ended December 31, 2008. This remaining variance is considered immaterial.

Other income was \$330 thousand for the three months ended June 30, 2009, an increase of \$189 thousand, or 134.04% from \$141 thousand for the comparable period in 2008. The most significant increases were in fees and premiums recognized on mortgage sales for the quarter. With long rates being at historical lows, this activity has picked up in the current year. Income recognized through mortgage sales is up \$138 thousand, or 336.59% at \$179 thousand when comparing the second quarter of 2009 to the same period in 2008, which came in at \$41 thousand.

Other income was \$494 thousand for the six months ended June 30, 2009, an increase of \$231 thousand, or 87.45%, from \$263 thousand for the comparable period in 2008. As with the quarterly results, the most significant increases were in fees and premiums recognized on mortgage sales for the quarter which are up \$161 thousand, or 240.30% at \$227 thousand when comparing the first six months of 2009 to the same period in 2008, which came in at \$66 thousand.

Gains on security sales were \$339 thousand for the three months ended June 30, 2009 compared to losses of \$10 thousand for the comparable period in 2008, an increase of \$349 thousand. This variance is the result of market opportunities to sell higher yielding securities at a gain as well as an exchange of one of the Company's common stock available for sale securities for common stock available for sale security in another entity. The transaction was structured so that 60% of the resulting company shares were recognized in cash and 40% were exchanged for shares in the new company. The result of this transaction was the realization of a \$248 thousand gain in the second quarter of 2009. As market rates have remained low, gains in the securities portfolio have become more common and the Company has taken advantage of these opportunities to continue the liquidation of securities that did not necessarily fit the desired security portfolio mix.

Gains on security sales were \$518 thousand for the six months ended June 30, 2009 compared to gains of \$16 thousand for the comparable period in 2008, an increase of \$502 thousand. The increase is due to opportunities provided by market conditions to sell some securities at gains as well as the merger transaction discussed with the quarterly results.

As previously mentioned in the discussion of securities, management evaluates securities for other than temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. As such, a determination was made in the first half of 2009 to record other than temporary impairment charges in relation to two equity positions held by the Company. The amount of impairment charged against income for the six months ended June 30, 2009 was \$136 thousand as compared to similar charges for the period ended June 30, 2008 of \$265 thousand. The amount of impairment charged against income for the quarter ended June 30, 2009 was \$60 thousand as compared to similar charges for the quarter ended June 30, 2008 of \$83 thousand. These securities will be monitored in future quarters for any further deterioration.

Other Operating Expenses:

Total other expenses increased 28.00%, or \$704 thousand, to \$3.218 million during the three months ended June 30, 2009 compared to \$2.514 million for the comparable period in 2008.

Total other expenses increased 18.63%, or \$964 thousand, to \$6.139 million during the six months ended June 30, 2009 compared to \$5.175 million for the comparable period in 2008.

Components of other expenses are as follows:

Salaries and benefits increased 20.80%, or \$235 thousand, to \$1.365 million for the three months ended June 30, 2009 compared to \$1.130 million for the same period in 2008. A partial contributor to the increase is additional branch staff in the current period when compared to the comparable period in 2008. The Glenburn Township branch location was opened in the fourth quarter of 2008 and thus the employment costs associated with this office would not have been incurred in this same period for 2008. Salaries and benefits are within the second quarter 2009 budgeted amounts.

Salaries and benefits increased 15.64%, or \$366 thousand, to \$2.706 million for the six months ended June 30, 2009 compared to \$2.340 million for the same period in 2008, also as a result of additional branch staff between the two periods as well as the addition of other support staff as the Company continues to grow. The full-time equivalent number of employees was 125 as of June 30, 2009 compared to 112 as of June 30, 2008.

Occupancy expenses increased \$26 thousand, or 14.94%, for the three month period ended June 30, 2009, to \$200 thousand, compared to \$174 thousand for the same period in 2008. This is considered to be in line, and actually below budgeted expectations.

Occupancy expense also increased \$67 thousand, or 18.01%, for the six month period ended June 30, 2009, to \$439 thousand, compared to \$372 thousand for the six month period ended June 30, 2008. Higher costs associated with winter maintenance of buildings (snow removal, salting, etc.), as well as the fact that one additional property in Glenburn Township is now being maintained accounts for the variance in this expense category for 2009.

Equipment expense increased \$17 thousand, or 14.91%, for the three month period ended June 30, 2009, to \$131 thousand, compared to \$114 thousand for the same period in 2008. Increased depreciation expense in relation to new office equipment and computer equipment accounts for \$13 thousand of the difference between periods. This variance is considered to be immaterial and is within budget expectations.

Equipment expense increased \$36 thousand, or 15.06%, for the six month period ended June 30, 2009, to \$275 thousand, compared to \$239 thousand for the six month period ended June 30, 2008. Again, increased depreciation expense in relation to new office equipment and computer equipment accounts for \$27 thousand of the difference between periods. The year to date variance is considered to be immaterial and is also within budget expectations.

FDIC insurance and assessments were up to \$453 thousand for the three months ended June 30, 2009 when compared to \$38 thousand for the same period in 2008. The increases in FDIC assessments for 2009 as well as the special assessment that has been levied on all insured financial institutions were previously discussed in Note 10 to the consolidated financial statements as included in this document.

Increases to FDIC insurance and assessments also had a significant effect on the year to date figure which increased to \$544 thousand for the six months ended June 30, 2009 when compared to \$75 thousand for the same period in 2008.

Professional fees and outside services increased \$23 thousand, or 20.00%, in the three months ended June 30, 2009 to \$138 thousand, compared to \$115 thousand for the three month period ended June 30, 2008. Professional services related to mortgage processing in the second quarter of 2009 in the amount of \$28 thousand account for the variance between periods. The Company did not incur similar costs in the second quarter of 2008.

Professional fees and outside services decreased \$9 thousand, or 3.16%, in the six months ended June 30, 2009 to \$276 thousand, compared to \$285 thousand for the same six month period ended June 30, 2008. This decrease is considered immaterial and is in line with budget expectations as decreases were projected for 2009.

Computer services and supplies increased \$49 thousand, or 21.30%, for the three months ended June 30, 2009, to \$279 thousand, compared to \$230 thousand for the comparable period in 2008. This increase is slightly ahead of budget expectations as the Company works to implement new technologies to its information technologies department. Increases projected for the quarter ended June 30, 2009 were \$35 thousand.

Computer services and supplies increased \$65 thousand, or 14.10%, for the six months ended June 30, 2009, to \$526 thousand, compared to \$461 thousand for the comparable period in 2008. This increase too is considered to be line with budget expectations, and is in fact slightly below projections for the second quarter of 2009. Increases were expected as the Company works to implement new technologies to its information technologies department.

Taxes, other than payroll and income, increased \$27 thousand, or 31.03%, to \$114 thousand for the three months ended June 30, 2009 compared to \$87 thousand for the same period in 2008. The increase is due to shares tax paid by the Company. The basis for this tax, among other criteria, is the asset base of the Company. As significant growth was experienced in loans and deposits between periods, the corresponding shares tax also increased. The shares tax accounts for \$26 thousand of this variance.

Taxes, other than payroll and income, increased \$33 thousand, or 18.64%, to \$210 thousand for the six months ended June 30, 2009 compared to \$177 thousand for the same period in 2008. The increase for the six months ended June 30, 2009 is also due to shares tax paid by the Company. The shares tax accounts for a \$35 thousand variance when comparing the six months ended June 30, 2009 and 2008.

Amortization expense-deposit acquisition premiums remained flat at \$64 thousand for the three months ended June 30, 2009 compared to the same period in 2008.

Amortization expense-deposit acquisition premiums also remained flat at \$129 thousand for the six months ended June 30, 2009 when compared to the same period in 2008.

Stationary and printing supplies increased \$1 thousand, or 1.09%, to \$93 thousand for the three months ended June 30, 2009 compared to \$92 thousand for the same period in 2008. This variance was within budget expectations.

Stationary and printing supplies increased \$13 thousand, or 7.65%, to \$183 thousand for the six months ended June 30, 2009 compared to \$170 thousand for the same period in 2008. This variance was within budget expectations.

All other operating expenses decreased \$89 thousand, or 18.94%, to \$381 thousand in the three months ended June 30, 2009, compared to \$470 thousand for the same three month period in 2008. The decrease is due to the elimination in 2009 of costs incurred in 2008 related to a commercial property in which a deed in lieu of foreclosure was taken. Overall costs associated with other real estate owned by the Company decreased for the quarter ended June 30, 2009 by \$90 thousand when compared to the same period in 2008.

All other operating expenses decreased \$76 thousand, or 8.20%, to \$851 thousand for the six month period ended June 30, 2009, compared to \$927 thousand for the same six month period in 2008. The decrease is also due to the elimination in 2009 of costs incurred in 2008 related to a commercial property in which a deed in lieu of foreclosure was taken. Overall costs associated with other real estate owned by the Company decreased for the six months ended June 30, 2009 by \$210 thousand when compared to the same period in 2008. The favorable variance was offset by an increase to marketing expenses which increased \$108 thousand for the six months ended June 30, 2009 when compared to the same period in 2008.

#### Income Tax Provision:

The Corporation recorded an income tax provision of \$193 thousand, or 13.35% of income, and \$516 thousand, or 23.24% of income, for the quarters ended June 30, 2009 and 2008, respectively.

The Corporation recorded an income tax provision of \$550 thousand, or 16.55% of income, and \$895 thousand, or 22.30% of income, for the six months ended June 30, 2009 and 2008, respectively. Decreases in the effective tax rate for the quarter ended, and year-to-date period ended June 30, 2009 is due to increased tax-exempt income in relation to total income.

#### Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Federal Reserve has now decreased the overnight borrowing rate to a range of 0% to 0.25% since they began their process of injecting liquidity into the financial markets through the implementation of lower overnight and discount rates. The Federal Reserve and Treasury Department have also acted in concert to drive longer term rates to historic lows as well as operating as a backstop to the financial industry through direct infusions of capital. The current environment could persist until such a time that credit markets are operating freely and/or inflation becomes a threat. As such, the Company is operating within a steep, albeit low rate yield curve environment which has allowed the Company to maintain a strong net interest margin. As of June 30, 2009, the Bank is currently showing more sensitivity to an upward rate shift scenario. The results of the latest financial simulation follow. The simulation shows a possible decrease in net interest income of 13.93%, or \$2.514 million, in a +200 basis point rate shock scenario over a one-year period. An increase of 4.27% or \$771 thousand is shown in the model at a -200 basis point rate shock scenario. The net interest income risk position of the Bank is within the guidelines established by the Bank's asset/liability policy for interest rate sensitivity testing. The variances are also within policy guidelines when tested over two full years. The percentage variances show a net interest income decrease of 10.49% when tested up 200 basis points and a decrease of 0.93% when tested down 200 basis points. The Bank continuously monitors this rate sensitivity and acts accordingly to minimize its risk to the overall asset liability position of the Company.

Equity value at risk is monitored regularly and is also within established policy limits. Please refer to the Annual Report on Form 10-K filed with the Securities and Exchange Commission for December 31, 2008, for further discussion of this matter.

#### Item 4. Controls and Procedures

##### (a) Evaluation of disclosure controls and procedures.

The Company's management, including the Company's Chief Executive Officer and Principal Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15(d)-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2009. Based upon that evaluation, the Chief Executive Officer and Principal Financial Officer concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were effective in timely alerting them to any material information relating to the Company and its subsidiaries required to be included in the Company's periodic SEC filings.

##### (b) Changes in internal controls.

There were no changes made in the Company's internal controls over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Although as stated above, we have not made any significant changes in our internal controls over financial reporting in the most recent fiscal quarter, based on our documentation and testing to date, we have made improvements in the documentation, design and effectiveness of internal controls over financial reporting, including the purchase of internal control software that allows upper management to view reports and to understand the risks and controls within the entire organization or specific areas of the organization. These reports provide up to date information at all times.

## PART II OTHER INFORMATION

#### Item 1. Legal Proceedings

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there are no legal proceedings that might have a material effect on the consolidated results of operations, liquidity, or the financial position of the Company at this time.

##### Item 1A. Risk Factors

No changes from those previously disclosed.



Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

| MONTH                          | Total number<br>of shares<br>purchased | Average price<br>paid per share | Total number<br>of shares<br>purchased as<br>part of publicly<br>announced<br>plans or<br>programs | Maximum<br>number of<br>shares that may<br>yet be<br>purchased under<br>the plans or<br>programs (1) |
|--------------------------------|--|---------------------------------|--|--|
| April 1, 2009 – April 30, 2009 | 0                                      | \$ 0                            | 0  | 65,751   |
| May 1, 2009 – May 31, 2009     | 0                                      | \$ 0                            | 0  | 65,751   |
| June 1, 2009 – June 30, 2009   | 0                                      | \$ 0                            | 0  | 65,751   |
| TOTAL                          | 0                                      | \$ 0                            | 0  |  |

(1) On July 2, 2001, the Board of Directors authorized the repurchase of an additional 5%, or 158,931 shares of the Corporation's common stock outstanding.

Item 3. Defaults upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

At the Annual Meeting of Shareholders held on April 25, 2009, Meeting Chairman, William E. Aubrey, reported that the Judge of Election and Proxies had completed the voting tabulations. On the basis of their report, he declared that Russell D. Shurtleff was elected for a three-year term.

I. Election of Class III Director

| NAME                    | FOR       | WITHHOLD<br>AUTHORITY |
|-------------------------|-----------|-----------------------|
| Russell D.<br>Shurtleff | 1,942,796 | 18,788                |

Class II Director whose terms will expire in 2010

William E. Aubrey II

Class I Directors whose terms will expire in 2011

George H. Stover, Jr.  
Richard S. Lochen, Jr.  
Ronald G. Kukuchka

Item 5. Other Information

None.



Item 6. Exhibits

- (3.1)Articles of Incorporation of Peoples Financial Services Corp. (1);
  - (3.2)Bylaws of Peoples Financial Services Corp. as amended (2);
  - (10.4)Termination Agreement dated January 1, 1997, between Debra E. Dissinger and Peoples Financial Services Corp.(1);
  - (10.6)Supplemental Executive Retirement Plan Agreement, dated December 3, 2004, for Debra E. Dissinger (3);
  - (10.7)Supplemental Director Retirement Plan Agreement, dated December 3, 2004, for all Non-Employee Directors of the Company (3);
  - (10.9)Amendment to Supplemental Executive Retirement Plan Agreement, dated December 30, 2005, for Debra E. Dissinger (4);
  - (10.10)Amendment to Supplemental Director Retirement Plan Agreement, dated December 30, 2005, for all Non-Employee Directors of the Company (4);
  - (10.11)Termination Agreement dated January 1, 2007, between Stephen N. Lawrenson and Peoples Financial Services Corp. (6);
  - (10.12)Termination Agreement dated January 1, 2007, between Joseph M. Ferretti and Peoples Financial Services Corp. (6);
  - (10.13)Employment Agreement dated February, 2007, between Richard S. Lochen, Jr. and Peoples Financial Services Corp. (5);
  - (11)The statement regarding computation of per-share earnings required by this exhibit is contained in Note 1 to the consolidated financial statements captioned "Earnings Per Share";
  - (14)Code of Ethics, as amended (8);
  - (21)Subsidiaries of Peoples Financial Services Corp. (7);
  - (31.1)Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), filed herewith;
  - (31.2)Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), filed herewith;
  - (32.1)Certification of Chief Executive Officer pursuant to Section 1350 of Sarbanes-Oxley Act of 2002, filed herewith; and
  - (32.2)Certification of Principal Financial Officer pursuant to Section 1350 of Sarbanes-Oxley Act of 2002, filed herewith.
- (1)Incorporated by reference to the Corporation's Registration Statement on Form 10 as filed with the U.S. Securities and Exchange Commission on March 4, 1998.
  - (2)Incorporated by reference to the Corporation's Exhibit 3.2 on Form 10-Q filed with the U.S. Securities and Exchange Commission on November 8, 2004.
  - (3)Incorporated by reference to the Corporation's Exhibits 10.6 and 10.7 on Form 10-K filed with the U.S. Securities and Exchange Commission on March 15, 2005.
  - (4)Incorporated by reference to the Corporation's Exhibits 10.9, and 10.10 on Form 10-K filed with the U.S. Securities and Exchange Commission on March 15, 2006.
  - (5)Incorporated by reference to the Corporation's Exhibit 10.13 on Form 8-K filed with the U.S. Securities and Exchange Commission on February 16, 2007.
  - (6)Incorporated by reference to the Corporation's Exhibits 10.11 and 10.12 on Form 10-Q filed with the U.S. Securities and Exchange Commission on May 10, 2007.
  - (7)Incorporated by reference to the Corporation's Exhibit 21 on Form 10-Q filed with the U.S. Securities and Exchange Commission on August 9,

2007.

(8) Incorporated by reference to the Corporation's Exhibit 14 as filed on Form 10-Q with the U.S. Securities and Exchange Commission on August 11, 2008.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PEOPLES FINANCIAL SERVICES CORP.

By/s/ Richard S. Lochen, Jr.  
Richard S. Lochen, Jr.,  
President

Date: August 10, 2009

By/s/ Frederick J. Malloy  
Frederick J. Malloy, VP/Controller/Principal Accounting Officer

Date: August 10, 2009

